



CORPORATE FRAUD **EXPOSED**

A Comprehensive and
Holistic Approach

H. KENT BAKER • LYNNETTE PURDA • SAMIR SAADI

CORPORATE FRAUD EXPOSED

Praise for Corporate Fraud Exposed

‘This book presents important insights into the causes and consequences of corporate fraud. The chapters encompass many useful empirical observations as well as key case studies. It is an important resource for academics, practitioners, and policymakers alike.’

– **Douglas Cumming**, DeSantis Distinguished Professor,
Florida Atlantic University

‘*Corporate Fraud Exposed* offers valuable insights on a wide cross section of timely, cutting-edge, fraud-related topics from essential background including causes and consequences, to detection and prevention, while highlighting case studies and areas for future research. From industry professionals to interested investors, readers will find this comprehensive work, from a mix of talented academics and practitioners led by highly accomplished co-editors, both intriguing and informative. As the editors point out, fighting fraud remains a never-ending battle with fintech and data analytics representing the latest battlefronts.’

– **Greg Filbeck**, CFA, FRM, CAIA, CIPM, PRM, Samuel P.
Black III Professor of Finance and Risk Management, Penn
State Behrend

‘This book is a unique one-stop-shop for understanding corporate fraud that provides a breadth of perspectives from a variety of academic disciplines. Summarizing the latest research and grounded in empirical data, the book provides valuable insights for students, academics, policymakers, investors, and practitioners alike.’

– **William J. Mayew**, Professor of Accounting, Duke University, Fuqua School of Business

‘This book provides a timely reminder of the inevitability of fraud, the costly societal consequences, and what can and can’t be done to detect and mitigate it. Readers will appreciate the multi-disciplinary and global perspective that brings together research on

well-known frauds of the past with frauds of the future enabled by technology (e.g. ‘crowdfooling’), showcasing evolving opportunities to address, from transparency, to whistleblowing to analytics.’

– **Alexander Dyck**, Professor of Finance and Economic Analysis and Policy, Rotman School of Management, University of Toronto

‘This book provides a wide-ranging coverage of the costly and growing epidemic afflicting the corporate and financial worlds: Fraud. An exceptional and coherent collection of well-researched chapters, *Corporate Fraud Exposed* reveals the pervasiveness of fraud and its dreadful impact on corporations and their stakeholders. It also offers an in-depth analysis of how fraud is committed and what can be done to prevent its occurrence in the first place. Given its holistic and forward-looking perspective, this book is valuable to academics, students, professionals as well as policy makers.’

– **Omrane Guedhami**, C. Russell Hill Professor of Economics, Moore School of Business, University of South Carolina

‘This is a terrific book! It not only demystifies and explains the phenomenon of corporate fraud but also exposes its complex and multifaceted nature. It covers cutting edge topics (e.g., cyber-fraud and ‘crowd-fooling’) on corporate fraud and uses detailed illustrations of major corporate scandals to demonstrate the global nature of fraud. The book’s clarity and comprehensive coverage of fraud make it a valuable reference for practitioners, policy makers, academics and graduate students alike.’

– **Kose John**, Charles William Gerstenberg Professorship in Banking and Finance, Stern School of Business, New York University

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A Comprehensive and Holistic
Approach

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CONTENTS

About the Contributors xi

Acknowledgments xxiii

Section 1 Nature of Fraud

1. Corporate Fraud Exposed: An Overview 3
H. Kent Baker, Lynnette Purda and Samir Saadi
2. Types of Corporate Fraud 19
Halil Kiyamaz
3. How Fraud Offenders Rationalize Financial Crime 39
Iva Charlopova, Paul Andon and Clinton Free
4. Accounting Principles and Corporate Fraud 61
Kirsten L. Anderson

Section 2 Causes and Determinants of Corporate Fraud

5. Corporate Culture and Fraud 85
Ellie Chapple, Kathleen Walsh and Yun Shen
6. Corporate Governance and Fraud 107
Ali C. Akyol
7. National Culture, Legal Environment, and Fraud 127
Chen Liu and Serena Shuo Wu
8. Agency Theory and Fraud 149
Chiraz Ben Ali

9. Executive Influence and Fraud 169
Philip R. Jones, Joseph Monts and Andrew C. Spieler

Section 3 Consequences of Corporate Fraud

10. Corporate Political Connections and Corruption 187
Matthew Boland
11. The Spillover Impact of Corporate Fraud on Peer Firms 205
Tashfeen Hussain
12. Crowdfunding without Crowd-fooling: Prevention Is Better Than Cure 221
Sondes Mbarek and Donia Trabelsi

Section 4 Corporate Fraud Detection and Prevention

13. Corporate Whistleblowing: Toward a Regulatory Approach 241
Anita Indira Anand
14. Forensic Accounting and Fraud Deterrence 261
Casey D. Evans
15. Cyber Security and Corporate Fraud 279
James K. Hayes
16. Law Enforcement Agencies and Corporate Fraud 299
Robert A. Warren and Michael Pakaluk
17. Financial Statement Fraud: Motivation, Methods, and Detection 321
S. David Young

Section 5 Corporate Fraud in Practice

18. Accounting Scandals: Enron, Worldcom, and Global Crossing 343
Steven Petra and Andrew C. Spieler

19. Panama Papers and the Abuse of Shell Entities <i>Carl Pacini and Nicole Forbes Stowell</i>	361
20. Stock Option Manipulations <i>Haifa Amairi, Boushra El Haj Hassan and Janelle Mann</i>	383
21. Satyam Scandal <i>Yan Luo and Linying Zhou</i>	403
22. Corporate Fraud: The Cases of Barings Bank, Volkswagen, and HIH Insurance <i>Sayan Sarkar and Andrew C. Spieler</i>	421
Section 6 Future Research Issues	
23. Corporate Fraud: Avenues for Future Research <i>Nadia Smaili, Julien Le Maux and Walid Ben Amar</i>	441
<i>Discussion Questions and Answers (Chapters 2–23)</i>	459
<i>Index</i>	491

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To write is human, to edit is divine.

–Stephen King

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Section 1

NATURE OF FRAUD

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CORPORATE FRAUD EXPOSED: AN OVERVIEW

H. Kent Baker, Lynnette Purda, and Samir Saadi

INTRODUCTION

After a major corporate scandal occurs, companies around the world are under increased pressure and scrutiny from market participants and law enforcement agencies to curtail deliberate actions aimed to deceive stakeholders. Yet, despite the increased regulatory activity, recent studies and global surveys document an alarming increase in the prevalence and severity of corporate fraud ([Global Fraud Survey 2015, 2016](#); [Reurink 2016](#); [Dyck, Morse, and Zingales 2019](#)). In fact, anyone can commit fraud at any level of an organization. The rapidly changing laws and regulations aimed at curbing corporate fraud continue to lag behind the changing sophistication of fraud schemes. Contrary to regulators, white-collar criminals exhibit superior abilities to swiftly adapt their fraud schemes to advances in technology, changes in economic development, and the emergence of new business models. This adaptability may explain why only one in four corporate frauds is detected in the United States. Corporate fraud is also widespread in the rest of the world. According to the “cockroach theory” of financial scandals, for everyone you see, hundreds more are hiding in the woodwork ([Anonymous 2004](#)).

Corporate fraud has become a worldwide phenomenon with large and far-reaching consequences on virtually all firms’ stakeholders and the economy as a whole. According to the [Association of Certified Fraud Examiners \(ACFE\) \(2018\)](#), each year the typical organization loses about 5% of its revenues to fraud, which translates into a total annual loss of \$74 trillion of gross world

product. In the United States, recent academic studies show that corporate fraud costs 20%–38% of a firm's market value (Dyck, Morse, and Zingales 2010, 2019; Karpoff, Lee, and Martin 2008). Although the bulk of the academic literature points to the negative impacts of fraud on shareholders' wealth, the literature is inconclusive on the nature and severity of consequences on executives once fraud is revealed (Karpoff et al. 2008). Moreover, some have recently questioned the quality of data used and the research design implemented in most US studies (Karpoff, Koester, Lee, and Martin 2017; Dyck et al. 2019). This revelation offers new avenues for academic research that reexamine the implications of corporate fraud not only in the United States but also around the globe.

The incontrovertible failure of financial regulators to prevent corporate fraud in the early 2000s created the impetus for the Sarbanes–Oxley Act (SOX) of 2002, a statute enacted by the US Congress and emulated in many other jurisdictions. Although a generally accepted belief is that SOX has improved corporate governance, whether SOX and similar statutes have substantially reduced corporate fraud remains unclear. In fact, field evidence shows that incidences of financial fraud have actually increased in the post-SOX era (PricewaterhouseCoopers 2005; Hogan, Rezaee, Riley Jr., and Velury 2008). The temptation for executives to enrich themselves at the expense of investors remains strong and the ingenuity of individuals who are bent on fraud is undiminished. Although the government has put additional antifraud regulations in place such as the Fraud Enforcement and Recovery Act of 2009 and extensions to whistleblower programs due to the Dodd–Frank Wall Street Reform and Consumer Protection Act of 2010, legislation may not be enough to curb financial fraud.

The enactment of antifraud legislation indicates that law enforcement agencies have become increasingly concerned with organizations' ability to resist corporate fraud from the lowest levels to the upper echelons of executive management. Survey evidence indicates that employees perpetrate the highest percentage of fraud schemes in a typical organization. Yet, the median loss caused by schemes perpetrated by owners/executives is 17 times greater than the typical loss caused by low-level employee schemes. Furthermore, these frauds take longer to uncover (Association of Certified Fraud Examiners 2018).

Corporate fraud has diverse roots and can be traced to many sources. Some of these sources involve the complex interplay between human vices including greed; access to resources that can be used to feed those vices, such as money provided by investors; corporate structures; and systems that enable senior executives to wrongfully partake of those resources including the granting of stock options. Another enabler of fraud includes a lack of oversight by internal and external stakeholders including middle managers and lower-level employees, audit committees, external directors, and securities regulators. The powerful incentives for leaders to engage in fraudulent misrepresentation of a company's performance and the near absence of effective checks and balances on executive decision-making have led to an epidemic of financial scandals touching many of the world's most prominent corporations.

ABOUT THIS BOOK

This section discusses the book's purpose as well as its distinguishing features and intended audience.

Purpose

The primary purpose of this scholarly book is to provide a holistic view of corporate fraud. Given the cross-disciplinary nature of corporate fraud, *Corporate Fraud Exposed: A Comprehensive and Holistic Approach* is written by experts in such fields as corporate governance, behavioral finance, law, auditing, and financial accounting. Discussion of relevant research permeates the book. This volume spans the gamut from theoretical to practical, while attempting to offer a useful balance of detailed and user-friendly coverage. Readers interested in a broad survey of fraud-related research will benefit as will those looking for more in-depth presentations of specific areas within this field of study. In summary, this book provides a fresh look at this intriguing and dynamic but often complex subject.

Distinguishing Features

Corporate Fraud Exposed: A Comprehensive and Holistic Approach has the following distinguishing features:

- The book provides an introduction to this broad, complex, and competitive field. It skillfully blends the contributions of a global array of scholars and practitioners into a single review of some of the most important topics in this area. The varied backgrounds of the contributors assure different perspectives and a rich interplay of ideas. The book also reflects the latest trends and research in a global context and discusses controversial issues as well as the future outlook for this field.
- The book is one of the few edited books on corporate fraud. Existing books, which are often written by professionals, are generally intended for a narrow audience such as auditors and forensic accountants. These books emphasize defining fraud and how it can be detected and prevented. This book, however, is intended for a broader audience.
- While retaining the content and perspectives of the many contributors, the book follows an internally consistent approach in format and style. Similar to a choir that contains many voices, this book has many contributing authors with their own separate voices. A goal of both a choir and this book is to have the many voices sing together harmoniously. Accomplishing this task for the book requires skilled editing to assure a seamless flow when moving from chapter to chapter. Hence, the book is collectively much more than a compilation of chapters from an array of different authors.
- This book places a strong emphasis on theory but more so on empirical evidence. When discussing the results of various studies, the objective is to distill them to their essential content and practical implications so they are understandable to a wide array of readers.
- The end of each chapter except the current chapter contains four to six discussion questions that help to reinforce key concepts. The end of the book contains guideline answers to each question. This feature should be especially important to faculty and students using the book in classes.

INTENDED AUDIENCE

Given its broad scope, this practical and comprehensive book should be of interest to investors, academics, researchers, practitioners, policymakers, criminologists, fraud prevention specialists, students, libraries, and anyone curious about corporate fraud. Investors can use this book to provide guidance in helping them navigate through the key areas involved in investing in corporate securities. For academics, the book offers the basis for gaining a better understanding about various aspects of financial fraud and acts as a springboard for future research. They can also use the book as a stand-alone or supplementary resource for advanced undergraduate or graduate courses in corporate governance and business ethics. Additionally, researchers, practitioners, fraud prevention specialists, criminologists, policymakers, students, and libraries should find this book suitable as a reference. Thus, *Corporate Fraud Exposed: A Comprehensive and Holistic Approach* should be essential reading for anyone who wants a better understanding of this important topic.

STRUCTURE OF THE BOOK

The remainder of this book consists of 22 chapters divided into six sections. A brief synopsis of each section and chapter follows.

Section 1: Nature of Fraud

Besides the current chapter, this part contains three other chapters (Chapters 2–4) that provide important background information that sets the stage for the remaining sections.

Chapter 2: Types of Corporate Fraud (Halil Kiyamaz)

This chapter examines the types of corporate fraud. Although corporate fraud comes in many forms, the chapter classifies fraud into asset misappropriation, corruption, and financial statement fraud. Asset misappropriation is often

referred to as employee fraud involving the theft of cash or noncash assets, skimming revenues, and billing. Many view financial statement analysis and corruption as management fraud. Corruption is dishonest and fraudulent conducts of those in power. Fraud surveys show that asset misappropriations are the most commonly occurring frauds, followed by fraud involving corruption. Financial statement frauds account for only a fraction of cases. Although the cost of asset misappropriation fraud is considerably smaller than other types of frauds, the highest monetary loss occurs with financial statement fraud. Survey results also show that the most substantial portion of frauds takes place in private companies and companies with fewer than 100 employees.

*Chapter 3: How Fraud Offenders Rationalize Financial Crime
(Iva Charloпова, Paul Andon, and Clinton Free)*

Fraud and related financial crime continue to impose substantial costs on businesses and economies throughout the world. A core element of fraudulent offending is the notion of rationalization. It occupies a cornerstone position in the *fraud triangle*, a framework for understanding fraud that is embedded in auditing standards and a mainstay of forensic accounting texts. However, rationalization is poorly understood. This chapter provides a systematic review of the diverse streams of research that consider the concepts of rationalization and neutralization to understand the nature and operation of rationalization in fraud offending. It also identifies the primary types of rationalization presented in accounting research to date. The chapter concludes by identifying productive avenues for future research promising to open up the black box of offender rationalization.

*Chapter 4: Accounting Principles and Corporate Fraud
(Kirsten L. Anderson)*

Financial reporting in the United States is guided by generally accepted accounting principles (GAAP). Within this framework are 10 basic financial accounting principles that dictate how financial statements are presented and how firms should account for business transactions. Most firms follow these principles steadfastly and report reliable financial reports upon which investors, creditors, and other interested parties can rely. Yet, some managers engage in fraudulent financial reporting activity that violates these principles. This chapter examines these 10 principles and their violation in recent years.